No. 12520.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

FLO PARKER AND ELGIN R. PARKER,

Appellants,

vs.

HARRY C. WESTOVER, Individually and as Collector of Internal Revenue for the Sixth District of California,

Appellee.

On Appeal From the United States District Court for the Southern District of California Central Division

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BRIEF FOR THE APPELLANTS.

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TOPICAL INDEX

PAGE

V.

TABLE OF AUTHORITIES CITED

Cases

Statutes

Textbooks

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BRIEF FOR THE APPELLANTS.

Judgments Below.

The consolidated cases were tried before a jury, and verdicts were rendered for appellee [R. 34] and judgments thereon were entered on January 12, 1950. [R. 39.] No opinions were written.

Jurisdiction.

These proceedings involve suits for recovery of Federal individual income taxes for the calendar year 1944, in the amounts of $63,477.71 and $63,509.01 for Flo Parker and Elgin R. Parker respectively, plus interest thereon at six per cent (6%) per annum from the respective dates of payment of said sums to the appellee. [R. 9 and 24.]

Appellants are husband and wife and live at 120 South Burris Street, Compton, California. [R. 2, 10, 16, 17, 25.]

On March 15, 1945, appellants filed with the appellee, ths Collector of Internal Revenue for the Sixth District of California, their income tax returns for the calendar year 1944. On July 9, 1947, appellants received from the appellee as Collector of Internal Revnue, notices and demands for payment of additional 1944 income taxes, plus interest as follows:

	Tax	Interest	Total
Flo Parker	$55,562.19	$7,665.30	$63,227.49
Elgin R. Parker	55,589.70	7,666.19	63,255.89

[R. 3, 11, 17, 25, 26.]

Appellants paid to appellee as Collector of Internal Revenue said taxes and interest demanded by appellee as follows:

	Tax	Interest	Total
Flo Parker 7-12-47	$27,590.01	$3,749.20	$31,339.21
Flo Parker 8-8-47	27,972.18	4,166.32	32,138.50
Total	$55,562.19	$7,915.52	$63,477.71
Elgin R. Parker	$27,617.52	$3,752.99	$31,370.51
Elgin R. Parker	27,972.18	4,166.32	32,138.50
Total	$55,589.70	$7,919.31	$63,509.01

[R. 3, 11, 18, 26.]

On January 23, 1948, appellants filed with appellee, claims for refund of 1944 federal income taxes in the respective amounts of $55,562.19 and $55,589.70 and interest paid thereon. The grounds of the claims were the same as those set out in the complaints subsequently filed. [R. 4, 18, 11, 26.]

Neither the appellee nor the Commissioner of Internal Revenue audited appellants' claims within six months of their filing, and appellants brought suits against appellee in the United States District Court for the Southern District of California, Central Division. Jurisdiction was conferred on such Court by Section 3772 of the Internal Revenue Code.

Judgments were entered in favor of appellee and against appellants on January 12, 1950. [R. 39.]

Within sixy days and on February 9, 1950, Notice of Appeal and Cash Bond were filed with the Clerk of the District Court, Southern District of California, Central Division. [R. 40, 41.] On March 27 and 28, 1950, Statement of Points Relied on and Designation of Portions of Record on Appeal were filed with said clerk. [R. 42, 43, 44.]

Jurisdiction is conferred on your Honorable Court by Section 1291 of Title 28 of the United States Code.

Statement of the Case.

These proceedings are appeals from the verdicts of the jury and judgments of the District Court of the United States, Southern District of California, Central Division, which determined that appellants were taxable on all the income of the partnership called Southern Heater Company for the fiscal year ended October 31, 1944, and that their children were not to be recognized as partners for Federal Income tax purposes, and that the appellants were not entitled to refunds of individual income taxes for the calendar year 1944 in any amount.

The question for review is whether the four children of appellants are to be recognized as partners for income tax purposes, for the fiscal year of the partnership ended October 31, 1944, or whether the children are to be ignored as partners so that the appellants would be taxable on all the income of the partnership.

The entire record in condensed form has been brought up for review.

As of October 31, 1943, appellants each owned as their separate property [R. 47, 71], a half interest in the assets and business of a partnership known as Southern Heater Company. Elgin R. Parker managed that business and took a salary of $12,000.00 a year from it. Flo Parker did not work in that partnership nor did she sign checks for the partnership. That firm was dissolved in November of 1943. [R. 47, 60.]

On October 31, 1943, each appellant gave to each of his or her four children, a six and one-quarter per cent (6¼%) interest in a business known as the Southern Heater Company. [R. 47.] The gifts were represented by deeds which were executed by appellants in the proper manner and immediately recorded in the office of the County Recorder, Los Angeles County. [R. 67 to 71, incl.] Such gifts were absolute and unconditional. [R. 48.]

The purpose of appellants in making these gifts was to try to tie the children into the business so that the family would be kept together and the business would be continuous. Furthermore, the appellants had been in bankruptcy before and they wanted the children to have some assets and income of their own, for their protection. [R. 47, 59.]

The appellants went into bankruptcy in 1936 due mostly to real estate investments and foreclosures of mortgages and deficiency judgments. Thereafter they acquired the new business by saving some of Mr. Parker's salary and by receipt of a gift from a brother-in-law and sister. [R. 46.]

Appellants' four children were Dian, born in 1920; Patricia, born in 1932; Roland, born in 1937, and Arthur, born in 1940. [R. 46, 47.]

Appellants decided to make the gifts to the children and take the children into partnership before they talked to their accounting or legal or tax advisors. Upon talking to such advisors, they were advised that if they made the transfers unconditionally, and took an adequate salary for the services of the parents, and the rights of the children as partners were fully recognized and protected, the children should be recognized as partners for income tax purposes and be taxable on their own share of the income [R. 52, 53, 54, 57], but that the Commissioner of Internal Revenue would probably contend that the children should be ignored as partners. Thereafter, they went ahead with the transaction.

Before the gifts were made and before the partnership was entered into, Elgin R. Parker realized that the proposed transaction might result in a saving of income taxes for the family. [R. 58.] Flo Parker never realized that there were any possible income tax savings involved in the transactions. [R. 59, 60.]

After making the gifts, Elgin R. Parker applied to the Superior Court of the county in which they were living for appointment as guardian of the properties of the children, so that the children would have someone to look after the assets, under the supervision of the Court. [R. 47.] The Superior Court in Orange County in Docket Number A-11392, appointed Elgin R. Parker guardian, provided he file four corporate surety bonds of $23,000.00 each. [R. 78.] Several surety companies were approached but they declined to go on the bonds in view of the hazards of the business and the danger that, if at the maturity of the children, the business had operated at a loss, the children would sue the guardian and his surety for recoupment. Eventually a surety company was found which stated that it would go on the bonds of the guardian provided he obtain orders of the Court—(1) instructing the guardian to enter into a partnership agreement with the other owners of the business, and (2) instructing the guardian to keep the property of the wards invested in the partnership interests, and (3) give the guardian authority as partner to retain in the partnership some of the income of the business if it were not all distributed. [R. 48.] Accordingly, Elgin R. Parker applied to the Court for these instructions and obtained such instructions so that he was able to meet the requirements of the surety company. [R. 47, 48, 73, 78.]

Evenually the bonds were written and filed [R. 67], whereupon Elgin R. Parker was appointed guardian and Letters of Guardianship were issued. [R. 78; F and G.]

Articles of Co-partnership were prepared and presented to the Court and approved and signed by the appellants for themselves and Elgin R. Parker as guardian for the four children. [R. 78; D and E.] The partnership agreements took effect as of November 1, 1943. [R. 82-89; Exhibit 4.] The Articles of Co-partnership were amended on July 7, 1945, and May 24, 1946, the principal amendment being to reduce Elgin R. Parker's salary to $2,400.00 per year when the active business assets of the partnership were transferred to corporations whose stock was owned by the partnership. [R. 92.]

Under California law, each partner had an equal voice in the management of the business and hence, the Superior Court had four votes against two for the appellants. [R. 82 to 89, incl.; Section 15018(e) of California Corporations Code (Partnerships).]

Since November 1, 1943, the guardian has filed annual accounts with the Court and had such accounts approved, and has operated and managed the guardianship estates and the partnership, under the supervision and jurisdiction and under the orders of the Probate Court. [R. 79, 80, 109; Defendant's Exhibit A; R. 108, 120, 121.]

The partnership filed certificates of fictitious firm name in the offices required by the California law. [R. 92, Exhibit 7.]

The business of the partnership grew after November 1, 1943, and most of the earnings were retained to carry on the expanded business. [R. 57.] In the fall of 1945, however, there was a distribution to each guardianship estate of $3,750.00 over and above the amount necessary to pay income taxes, which sum was invested in United States Government Bonds and held by the guardian for the several guardianship estates. [R. 53, 98.]

As of May 1, 1946, most of the personal property of the business was transferred to two corporations and the stocks of the corporations were issued to the partnership. [R. 92; Exhibit 10; R. 108, 109, Nos. 3 and 4.] The Articles of Co-partnership were amended May 24, 1946, to provide that the partnership should not carry on the business of manufacturing and selling water heaters or brass specialties since the corporations had taken over the operation of these businesses. [R. 92, Exhibit 10.] From May 1, 1946, until September 1, 1948, the operations of the partnership consisted solely of rental of real estate and holding of capital stock. On September 1, 1948, the real estate was transferred to another corporation which issued its stock to the partnership. [R 121; Nos. 9 and 10.] From September 1, 1948, until October 31, 1948, the operation of the partnership consisted solely of holding capital stock.

The partnership was dissolved as of October 31, 1948, and each guardianship estate received its share of the assets, which amounted to $84,589.92 for each guardianship. [R. 49, 92; No. 12; 93-97, incl., 98.]

The appellants continued to support their children after November 1, 1943, and none of the earnings of the children have been used for their support or for that of the parents. [R. 48.]

The guardianships have not sold any property to the appellants nor have the guardianships suffered any losses. The guardianships have expended money for income taxes and premium on bonds and attorneys' fees. [R. 48.]

The original combined gift to each child on October 31, 1943, had a book value of $24,745.98. [R. 5, 12; 19, 20, 27.] As of October 31, 1948, when the partnership was dissolved, each guardianship received assets from the partnership with a book value of $84,589.92 and in addition had $3,750.00 in United States Government Bonds or a total of $88,339.92. [R. 49, 98, 100.] These assets are held in the guardianships and will be distributed to the children when they become of age.

The appellants filed Federal and State gift tax returns for the calendar year 1943 and reported the gifts to the children of the interests in the business, totalling $98,-984.90. Appellants paid the Federal and State gift taxes shown to be due. [R. 5, 12, 19, 20, 27.] Subsequently, the Commissioner of Internal Revenue determined that the transfers were complete and irrevocable and constituted taxable gifts, and determined the value of the gifts to be $212,500.00 and determined that deficiencies in gift taxes were due. Appellants paid the additional Federal gift taxes totalling $16,035.00. In arriving at the above values for gift tax purposes, the Commissioner of Internal Revenue, in valuing the goodwill of the business, used a salary of $12,000.00 for Mr. Parker in computing the past earnings and in estimating the future earnings of the partnership. [R. 5, 12, 20, 27.] The Commissioner has not refunded said gift taxes. [R. 48.]

The income of the partnership for the fiscal year ended October 31, 1944, after paying a salary of $12,000.00 to Mr. Parker, was approximately $252,000.00. Appellants were entitled to fifty per cent (50%) thereof or $126,-000.00 plus the $12,000.00 salary, making their total share $138,000.00. After the Commissioner of Internal Revenue disregarded the children as partners, he demanded a total tax from appellants of $193,000.00. This was $55,000.00 more than appellants had a right to receive from the partnership for the year 1944. Under the Commissioner's ruling the children would receive $126,000.00 from the partnership, free from income tax. [R. 49.]

As a result of the above situation, appellants filed an application to the Superior Court to adjust the division of the partnership income. [R. 49.] The petition asked that the Court authorize the appellants to take or use the refunds of Federal income tax which would be paid to the children for the year 1944 upon the following conditions:

(1) If appellants won their income tax cases, they would return the refunds to the children, with the interest benefits that had been received.

(2) If appellants lost their income tax cases, they would keep the children's refunds and be free to apply to the Court for a further adjustment of the partnership income on account of the income tax situation. This application covered Federal income taxes as well as California income taxes. [R. 101 to 104, incl.] The Court granted the petition. [R. 105 to 107, incl.] This petition and order superseded an earlier petition for an adjustment for taxes which the Court did not act upon. In that earlier petition appellants asked that the income of the partnership, after the total family income taxes on the partnership income had been deducted, be divided in accordince with the interest of the partners; that is, fifty per cent to the appellants and fifty per cent to the children. [R. 110 to 116, incl.]

The salary paid to Elgin R. Parker for the fiscal year ended October 31, 1944, was arrived at after checking with various officials of different companies as to what they were receiving for like work, and taking into consideration the fact that Mr. Parker was getting $12,000.00 per year from the previous partnership with his wife, and the fact that he had never before received a salary in excess of $12,000.00 from any employer. The $12,000.00 salary was about twice as much as any other executive of the partnership received. The certified public accountant who served the business had access to other concerns and he thought that $12,000.00 would be a fair salary for the services of Elgin R. Parker. It was intended to be a full and adequate salary for the services rendered to the partnership by Elgin R. Parker. [R. 50, 51.]

The business of the partnership increased in the fiscal year ended October 31, 1944, and the income for that year was produced by the existence of the plant, the capital, the going organization and the ability or good luck in getting allocations of materials to manufacture water heaters, and, of course, labor and management. [R. 50.] As of October 31, 1943, the business was being run on a three months' basis; that is, when an allocation of material was received, the management could set up a program for three months. Beyond that it could not determine what the future would be. This made it uncertain as to whether the company could stay in the water heater manufacturing business, as water heaters were not considered essential, and the company might not get further allocations of materials. Under these facts the appellants did not know as of October 31, 1943, whether or not they would make a profit. [R. 50.]

Appellants intended that the gifts to the children be genuine, complete and unconditional and intended to enter into *bona fide* partnership between themselves and the children and intended, in good faith, to conduct the business of the Southern Heater Company in partnership with the children. [R. 48, 51.]

All of the important steps taken after the formation of the partnership were taken after Elgin R. Parker had applied to the Court for instructions and had received his instructions on the contemplated steps. This included the transfer on May 1, 1946 and September 1, 1948, of some of the partnership assets into several corporations and the issuance of the corporate stocks to the partnership. [R. 51.]

After appellants gave a half interest in the assets and business to their children, the income of the appellants was cut in half and the ownership of their assets was cut in half. Their living expenses went on as before, except that the appellants had to pay for them out of half of the income they formerly had. [R. 51.]

The net income of the business prior and subsequent to forming the partnership was approximately as follows:

1940	$ 22,500.00
1941	60,000.00
1942	93,000.00
The period of Jan. 1. 1943 to October 31, 1943	140,160.00
Fiscal year ended October 31, 1944	260,576.89
1945	231,137.16
1946	306,050.28 [R. 52]

Neither the children nor Flo Parker contributed any services to the partnership at any time. [R. 54.] Flo Parker did not sign checks or render any service to the partnership. [R. 59.]

The Commissioner of Internal Revenue refunded the 1944 income tax that each child paid, in the approximate amount of $13,986.09 with interest. [R. 67.] With the approval of the Superior Court, the appellants used these refunds to help pay their additional taxes for 1944. [R. 105 to 107, incl.]

Capital, both tangible and intangible, were material income producing factors and the children owned half of the tangible and intangible capital. [R. 50, 5, 12, 20, 27.]

The salary of $12,000.00 per year paid to Elgin R. Parker by the partnership for the fiscal year ended October 31, 1944, was equal to the value of his services rendered to the partnership for that year. [R. 50, 51, 62, 63.]

The partnership with the children, as shown throughout the record, was created with all legal formalities and was held out as a partnership in all dealings with the tax authorities, the surety company, the probate court and the creditors.

The children reported their shares of the partnership income in their individual returns and paid taxes thereon. [R. 67, 97.] The partnership was legal under California law. The partnership filed Federal and State income tax returns as a partnership. [R. 52, 97.] This was a partnership for common law purposes.

The children, through the Probate Court, exercised dominion and control over their interest in the partnership business, they enjoyed their share of the earnings and they contributed capital to the partnership, which capital was material and income producing.

The gifts and formation of the partnership were consummated for a business purpose. The possible saving of income tax was not known to Flo Parker and was only an incidental object to Elgin R. Parker in making the gift.

Statute and Regulations Involved.

Section 181 of the Internal Revenue Code provides as follows:

> "Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity."

Section 182 of the Internal Revenue Code provides:

> "In computing the net income of each partner, he shall include, whether or not distribution is made to him—(a) As part of his gains and losses from sales or exchanges of capital assets held for not more than six months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for not more than six months. (b) As part of his gains and losses from sales or exchanges of capital assets held for more than six months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for more than six months. (c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in Section 183(b)."

Section 3797(a)(2) of the Internal Revenue Code defines partnerships and partners as follows:

> "The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust

> or estate or a corporation; and the term 'partner' includes a member in such a syndicate, group, pool, joint venture, or organization."

The Regulations do not add anything to the above provisions.

Statement of Points Relied On.

Appellants rely upon the following specified errors in their prosecution of these appeals:

1. The Court erred in failing to give the appellants' requested instructions Nos. 24, A, C, L and appellants took exception thereto.

2. The Court erred in giving appellee's requested instruction, No. 31, over the objection and exception of the appellants.

3. The Court erred in admitting, over appellants' objection, Memorandum *in re* Incidence of Federal Tax Liability on 1944 Partnership Income.

4. The Court erred in admitting, over appellants' objection, Application for Authority to Compromise Claims (6 pages) (Filed August 27, 1946).

5. The evidence is insufficient to justify the verdicts of the jury. [R. 42.]

ARGUMENT.

I.

Summary of Argument.

The Court's refusal to give the appellants' requested instructions to the effect that an intra-family gift of an interest in a business could be sufficient to constitute the donees partners for income tax purposes, lead the jury to the conclusion that the children's contribution in the case at bar was not sufficient to support a verdict that they could be recognized as partners for income tax purposes. The direct result of the Court's rulings and failures to give rulings, was that the jury thought there had to be original contributions of capital to the partnership by the new members, contrary to the principles laid down by the Supreme Court in *Commissioner v. Culbertson,* 337 U. S. 733.

If the Court had properly instructed the jury and had told it in affirmative language that the intra-family gift to the children, of interests in the business was sufficient to support a finding that the children could be valid partners, the jury would have found for the appellants.

The giving of the appellee's requested instruction No. 31 over the objection and exception of the appellants, gave the jury the impression that because the parents gave interests in the business to their children, the parents were necessarily taxable thereon, contrary to the principle set forth in *Commissioner v. Culbertson, supra.*

The Court's error in admitting over appellants' objection, "Memorandum *in re* Incidence of Federal Income Tax Liability on 1944 Partnership Income," raised doubt in the minds of the jury as to whether the $12,000.00 salary paid by the partnership to Elgin R. Parker was sufficient to fully compensate him for the services rendered to the partnership. There was no other evidence raising such doubt. This gave appellee a chance to argue that if Parker's services were worth more than $12,000.00 per year, it would mean that some of the value of his services, which should have been reported on the appellants' returns, was reported on the returns of the children.

The Court's error in admitting over appellants' objection, "Application for Authority to Compromise Claims," filed August 27, 1946, gave the jury the impression that the appellants were acting as opportunists in prosecuting their suits for refunds, inasmuch as E. R. Parker, in said application recited that the law of family partnerships was greatly in favor of the Government. Actually, by the time of the trial, January, 1950, the law had greatly changed, due to the Supreme Court's decision (June 27, 1949), in *Commissioner v. Culbertson, supra.* In any event, the Application for Authority to Compromise Claims contained a layman's opinion as to this matter of law, which, of course, should not be admitted in evidence as an admission against interest or in any manner reduce his chances of success.

The evidence was wholly insufficient to support the implied finding of the jury that the partnership with the children was a sham and was not entered into for the *bona fide* purpose of carrying on the business in partnership form.

II.

The Effect of the Court's Rulings on Instructions to the Jury Was to Give the Jury the Erroneous Impression That Original Capital Contributions to the Partnership Were Necessary, and That the Gifts to the Children of Interests in the Business Were Not Sufficient to Support a Finding That the Children Could Be Bona Fide Partners for Tax Purposes.

In *Commissioner v. Culbertson,* 337 U. S. 733, the Supreme Court granted certiorari to consider the Commissioner's claim that the principles of *Commissioner v. Tower,* 327 U. S. 280, and *Lusthaus v. Commissioner,* 327 U. S. 293, had been departed from in the *Culbertson* case and other Courts of Appeal decisions. The Supreme Court in *Commissioner v. Culbertson, supra,* said that the Tax Court had read the *Commissioner v. Tower, supra,* and the *Lusthaus v. Commissioner, supra,* decisions as setting out two essential tests of partnership for income tax purposes: that each partner contribute to the partnership either (1) vital services or (2) capital originating with him. The Supreme Court said that the Tax Court had found sanction for the use of these "tests" of partnership from certain language in the *Tower* case. In *Commissioner v. Culbertson, supra,* it was the Commissioner's contention that the Tax Court's decision (in favor of the Government) could and should be reinstated upon the mere reaffirmation of the quoted paragraphs. The Court then turned to a consideration of the Tax Court's approach to the family partnership problem wherein the Tax Court treated as essential to membership in a family partnership for tax purposes, the contribution of either vital services or original capital. The Court said:

> "The use of these 'tests' of partnership indicates, at best, an error in emphasis. It ignores what we said is the ultimate question for decision, namely, 'whether the partnership is real within the meaning of the Federal Revenue Laws' and makes decisive what we described as 'circumstances (to be taken) into consideration' in making that determination."

The Supreme Court then said that *Commissioner v. Tower, supra,* provides no support for such an approach as the Tax Court took.

The Supreme Court said:

> "The Tax Court's isolation of 'original capital' as an essential of membership in a family partnership also indicates an erroneous reading of the Tower opinion. We did not say that the donee of an intra-family gift could never become a partner through investment of capital in the family partnership, any more than we said that all family trusts are invalid for tax purposes in *Helvering v. Clifford*, 309 U. S. 331. The facts may indicate, on the contrary, that the amount thus contributed and the income therefrom should be considered the property of the donee for tax, as well as general law, purposes."

Later the Supreme Court in *Commissioner v. Culbertson, supra,* said:

> "If the donee of property who then invests it in the family partnership exercises dominion and control over that property—and through that control influences the conduct of the partnership and the disposition of its income—he may well be a true

partner. Whether he is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprse."

In that view of the law, the appellants requested the Judge in the case at bar to make the following instructions:

"No. 24. One of the elements that you may consider in determining the validity of this partnership is the capital that was put into the business. You may consider the source of the capital of the partners and the fact that the capital of the children was given to them by their parents. A parent can make a gift of property to his children, which is valid under the laws of California, and an outright gift carries with it the absolute parting with the control and dominion of the thing that is given, so that the donee or the party receiving the gift is absolutely free of his own will to do whatever the donee might desire to do with the property. You may consider whether the gifts in this case were absolute or subject to some condition or control by the parents.

"The fact that the children's share of the partnership was given to them by their parents would not prevent the partnership from being valid for income tax purposes, if the gift were complete and the partners really intended to form a genuine partnership. *Thomas vs. Feldman,* 158 Fed. (2d) 488. *Armstrong vs. Commissioner,* 143 Fed. (2d) 700.

"No. A. It is the law that the donee of an intra-family gift can become a partner for Federal income tax purposes through investment of the capital in the family partnership. *Commissioner vs. Culbertson,* 69 Supreme Court 1210.

"No. C. You are instructed that if you believe from a preponderance of the evidence that the plaintiffs here gave interests in the business assets to their children, absolutely and unconditionally, and that thereafter the parents' economic situation was reduced by the capital they gave the children, and the income therefrom, and that the parents intended in good faith to have a bona fide partnership between themselves and the children for the operation of the business, then your verdict shall be for the plaintiffs. *Commissioner vs. Culbertson,* 69 Supreme Court 1210.

"No. L. The fact that transfers to members of the family group may be mere camouflage does not, however, mean that they invariably are. If the donee of property invests it in the family partnership and exercises dominion and control over that property—and through that control influences the conduct of the partnership and the disposition of its income—he may well be a true partner. Whether he is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise. *Commissioner vs. Culbertson,* 69 Supreme Court 1210." [R. 31 to 33, incl.]

Appellants took exception to the Court's refusal to give the requested instructions. This matter appears on page 157 of the Record and is as follows:

"Mr. Wilson: Thank you. I except to the omission of our requested instruction No. 24. [157]

The Court: An exception to the court's refusal to give plaintiffs' requested instruction 24 will be noted. I want to call your attention to the fact that everything requested in your instruction 24 was covered by the court's instruction. This instruction is argumentative in form and it emphasizes certain facts in this case which the court has purposely avoided doing.

Mr. Wilson: And No. A in the supplemental is the next one.

The Court: Exception noted. I considered that as being covered.

Mr. Wilson: And No. C, your Honor.

The Court: Exception noted.

Requested instruction L, I gave in part.

Mr. Wilson: Only the first part, your Honor.

The Court: Yes, the last part I omitted, and an exception will be noted. [188]"

Attention is called to the fact that the counsel for the respective parties had filed requests for instructions prior to the trial and had met in the Judge's chambers and discussed the instructions with the Judge, with the result that the Judge knew the views of counsel with respect to the law of family partnerships and particularly the view of appellants' counsel with respect to donated property being the donee's contribution to the partnership. Hence, it was unnecessary for appellants' counsel to dwell on the grounds for his exception, since these were well known to the Judge and the Judge's views on this subject known to counsel.

Now those requested instructions of the appellants were directly in line with the language used by the Supreme Court in the *Commissioner v. Culbertson, supra,* and should have been given to the jury as nearly as possible in the Supreme Court's language.

Now did the Court instruct the jury that it was not necessary for the children to contribute original capital to the partnership? On page 145 of the Record the Court said:

> "A gift of an interest in a family business, whether absolute or in trust, which makes no real change in the economic situation of the group or in the control or management of the business, will not reduce the obligations of the donor to account for and pay income tax on the earnings of the enterprise to the same extent as before the gift was made."

On pages 146 and 147 of the Record the Court said:

> "In considering whether or not the partnership with the minor children is of sufficient substance to justify the splitting of the income of the business for Federal Income Tax purposes, you may do so with the realization that the relationship between members of a family often makes it possible for one of the members to shift tax incidence by surface changes of ownership without disturbing in the least his dominion and control over the subject of the gift for the purposes for which the income from the property is used. He is able, in other words, to retain the substance of full enjoyment of all the rights which he had previously in the property."

On page 147 the Court said:

> "The fact that transfers to members of the family group may be mere camouflage does not, however, mean that they invariably are."

On page 149 the Court said:

> "The transactions between the plaintiffs and their minor children should be carefully scrutinized by you and if you determine from all the facts that the plain-

> tiffs were able to retain the substance of all the rights which previously they had in the Southern Heater Company then you must determine that there was no valid partnership between the plaintiffs and their minor children for Federal income tax purposes during the year 1944."

The Court did not give the affirmative phase of the rule that donated capital could be sufficient.

As shown on page 158 of the Record, appellants took exception to the giving by the Judge of appellee's instruction No. 31. The Record, page 158, reads:

> "Mr. Wilson: Then No. 31. I except to defendant's No. 31, your Honor, as applied to this case.
>
> The Court: What is that instruction?
>
> Mr. Wilson: The one starting:
>
> 'You are instructed that common understanding and experience are the touchstones for the interpretation of the revenue laws. The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid. The one who earns income but gives the right to receive that income to a favorite child has enjoyed the benefit of that income within the meaning of the Internal [189] Revenue laws.'
>
> I think that ignores the property element, the ownership of property, and the fact that the property can earn income.
>
> The Court: I feel I covered that pretty well. I do not think I have unduly stressed the conflicting theories of either party. Exception will be noted."

Appellee's requested instruction No. 31, which the Court gave to the jury, read:

> "You are instructed that common understanding and experience are the touchstones for the interpretation of the revenue laws. The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid. The one who earns income but gives the right to receive that income to a favorite child has enjoyed the benefit of that income within the meaning of the Internal Revenue Laws. *Helvering vs. Horst* (1940), 311 U. S. 112; Section 22(a) of the Internal Revenue Code."

After the Court had given its original instructions and the appellants had taken exception to refusal to give the requested instructions, Nos. 24, A, C and L, and had taken exception to the giving of appellee's instruction No. 31, the jury retired and considered the matter for several hours. Then they came back to the court room and asked several questions. One of them was as follows:

> "Was the gift taken from the business and reinvested in the business considered a contribution to the welfare of the business?" [R. 158-B.]

They also asked for the definition of a partnership under the federal law and asked the Judge to reread the Instructions to the Jury with regard to family partnerships. [R. 158-B.]

The Court then read at least some of the instructions with regard to family partnerships but did not answer their question as to whether the gift taken from the business and reinvested in the business could be considered a contribution to the welfare of the business. The Court read again the negative statement with respect to a gift of an interest in a family business which is quoted on page 23 hereof. He did not give the jury the very information they were seeking; namely, the Supreme Court language with respect to original capital and with respect to gifts of interests in the business, which language appellants had requested the Judge to give and had taken an exception when he refused to do so.

Immediately upon the Judge repeating his negative instructions with respect to the gift, the jury went back to the jury room and unanimously voted against the appellants.

It was obvious to the Judge and counsel, that the jury was in doubt as to whether the children's contribution of capital had to be "original," or whether it could consist of interests in the existing business assets. It was also obvious that his original instructions had not cleared up the point, and that a re-reading of his original instructions would not remove the doubt.

Now the Judge knew what the Supreme Court in the *Culbertson* case said on the subject, because appellants had requested an instruction on the point, giving the *Culbertson* case as authority, and had taken an exception to the Judge's refusal to so instruct.

In Cyclopedia of Federal Procedure, Volume 7, page 641, the pertinent rule is stated as follows:

> "In giving additional instructions, the doubt which the jury manifests should be met by a charge tending to avert an error in that direction."

The Judge did not give them the instruction which had been requested by appellants and by the jury itself, and thus committed an error in the most critical point of the case. In effect, the Judge left a *legal* question to the decision of the jury, which is clearly erroneous. (64 Corpus Juris 584.)

Not only did the Judge refuse to give the appellants' requested instructions as indicated above, which lead the jury to the conclusion that contributions by the new partners had to be original contributions and an increment in the capital of the business, but he also gave instruction No. 31 over appellants' objections and exceptions, and it read as follows:

> "You are instructed that common understanding and experience are the touchstones for the interpretation of the revenue laws. The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid. The one who earns income but gives the right to receive that income to a favorite child has enjoyed the benefit of that income within the meaning of the Internal Revenue Laws."

The jury's obvious conclusion from the instructions of the Judge, was that since the parents had originally owned the capital and given an interest in it to the children, they were the ones who earned or created the right to the income from that property and were taxable on it even though they had given the income producing property to the children. This is contrary to the law as set forth by the Supreme Court in *Commissioner v. Culbertson, supra,* which says that an inter-family gift of an interest in the business can support a recognition of the donee as a partner.

In contrast to the instructions concerning these points as given by the Court below with the instructions given in other family partnership jury cases, please observe the instructions of the Court in a number of other cases set out below:

In *C. B. Fretwell v. Bowers,* U. S. District Court, Eastern District of South Carolina, Columbia Division, reported August 2, 1950, paragraph 72,685, 1950 Prentice-Hall Federal Tax Service, the jury upheld a family partnership consisting of the husband and wife and their adult son and trustee for a minor son. All but the husband made their contributions by gifts from other members of the family. The trial Judge, D. J. Timmerman, read the instructions requested by the respective counsel.

For the Government, he gave the instruction quoted on page 23 of this brief.

For the taxpayer, he gave an instruction as follows:

> "6. Members of the same family, including husband, wife and children, and a trustee for a member of the family, may form a partnership which is entitled to be recognized as a real partnership under the Federal Income Tax Laws. A partnership within the meaning of the Federal Income Tax Laws may be formed as a result of a gift by one member of a family to another member of the family. The reality of such a partnership depends upon the intention of the parties, just as in the case of a partnership between persons who are not members of the same family."

It will be noted that Judge Timmerman gave the affirmative as well as the negative instruction concerning a partnership based on a gift. In the *Parker* case, the Judge gave only the negative, which did not convey to the jury the law of the case, as enunciated by the Supreme Court.

Similarly, in *William M. Lamb v. Smith,* the United States Court of Appeals for the Third Circuit, on July 28, 1950, affirmed a judgment based on a verdict of the jury upholding a family partnership, in a trial in the United States District Court for the Eastern District of Pennsylvania. In the trial court, paragraph 72,395 of 1950 Prentice-Hall Federal Tax Service, the charge of the Court is shown. The Court instructed the jury as follows:

> "If the donee of property—that is a person who is given property—then invests it in the family partnership, exercises dominion and control over that property, and through that control influences the conduct of the partnership and the disposition of his income, he may well be a true partner. Whether he is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his partnership in the enterprise."

In *Mundo v. Thompson,* Paragraph 72.361 of 1950 Prentice-Hall Federal Tax Service, the jury in the United States District Court, Eastern District of Arkansas, Western Division, on November 1, 1949, upheld a family partnership, based in part on gifts to the new partner from the old one. The Court instructed the jury, in part, as follows:

> "Such capital contributions may be considered, whether the capital originated from Thelma Mundo's own funds or was received as a gift from plaintiff."

Compare those instructions with appellants' requested instructions, Nos. 24, A, C and L.

What a different imprint on the jury's mind the instructions in the cited cases make, as compared to the instructions given by the Court below.

In addition to the Court's refusal to give the appellants' requested instructions as to the efficacy of the gift as support for a family partnership, it might be interesting to note the general tenor of the Court's instructions with respect to other matters.

The Court, in its instructions, reminded the jury twice that there was a presumption that the Commissioner's determinations were correct. These reminders are found on the following pages of the record: 143 and 161.

Now when the jury came back into the courtroom and asked certain questions, they did not ask whether there was any presumption in favor of the determination of the Commissioner. Nevertheless the Court, in that brief interlude, and toward the close of the day and after the jury had been out several hours, incorrectly stated [p. 161 of the Record] that the jury had asked for certain instructions with reference to the findings of the Commissioner as being presumptively correct. The questions asked by the jury are shown on pages 158 and 159 of the Record and they certainly do not include such question. Nevertheless, the Court on page 161 raised that question and again reminded the jury that the action of the Commissioner was presumed to be correct.

The Judge should not have repeated that rule at that juncture of the trial. It was equivalent to telling the jury:

> "You are obviously divided in your votes. The hour is growing late. When you can't unanimously agree to vote for the appellants, the presumption in favor of the defendant should give you your answer.

If you don't quickly decide on a verdict, you will be locked up by the bailiff."

In Cyclopedia of Federal Procedure, Volume 7, page 642, the rule is shown as follows:

> "Instruction is properly limited to the questions asked by the Jury."

The Judge did not answer a critical question the jury asked, which if properly answered, would have benefited appellants, but instead, volunteered to repeat the "burden of proof on the plaintiff" rule, which aided the defendant. He also put pressure on them to quickly make a decision.

The appellants had already taken exception to the Judge's refusal to give appellants' instructions which would have directly cleared up the doubt in the jury's mind.

Again it might be interesting to find out how many times the Court instructed the jury that intra-family matters, particularly intra-family partnership matters, are subject to close scrutiny. Such instructions were given in the Record on the following pages: 145, 146, 147, 149, 159.

The rule on this point is stated in Randall's Instructions to Juries, Volume 1, Section 416, as follows:

> ". . . if the frequent repetition of a phrase or a proposition of law is misleading, or is such as to give undue prominence to certain features of a case, to the prejudice of one party or the advantage of another, it will constitute reversible error."

The Judge's constant repetition on this point gave appellants about as much standing, in the eyes of the jury, as convicted subversives.

Again it may be interesting to see how many times the Court reminded the jury that the appellants had the burden of proof. These instructions are found in the Record on the following pages: Record 144, 152 and 161.

While the United States Code provides that there can be no jury trial in a case against the United States Government (for the obvious reason that every juror who is a taxpayer would feel like he was one of the defendants), the Judge on page 141 stated that these suits were in reality against the United States, since if the taxpayers, plaintiffs in this action, recovered the judgment, it must be paid from the treasury of the United States. The Government Attorney made much of this point in his argument. He told the jurors that if they approved this claim against the "club," each member, including themselves, would have his "dues" increased.

It is believed that the effect of the Judge's instructions and refusal to give instructions was to create in the minds of the jury the impression that to be valid for income tax purposes, there must have been some contribution of services or management or capital which would improve the condition of the partnership or the business. In other words, there must have been some purpose other than tax saving, and that purpose had to relate to the business and could not be an extraneous purpose, such as benefiting the donees.

On pages 148, 149, 160 and 161, the Court referred to a *business* purpose.

As a matter of law, the Supreme Court has merely said that the question is whether there was a genuine purpose to carry on the business in partnership form.

It is obvious from the question asked by the jury [R. 158-B] that they considered that a purpose which would support a recognition of the partnership must be a contribution "to the welfare of the business." The Judge refused to give the instructions requested by the appellants to the effect that a contribution of original capital by the new members was not necessary. It was only necessary that they control the income from the donated property and that donors and donees intended that they should operate the business as a partnership.

If the Court had given the instructions requested by the appellants, the jurors would not have insisted on a contribution of original capital by the children and would have found the partnership involved should be recognized for income tax purposes. That was the result in three recent cases, where proper instructions were given. (*C. B. Fretwell v. Bowers, supra; Lamb v. Smith, supra,* and *Mundo v. Thompson, supra.*

III.

The Court Erred in Admitting Over Appellants' Objections "Memorandum in re Incidence of Federal Tax Liability on 1944 Partnership Income."

The appellants introduced competent evidence to the effect that the $12,000.00 salary which was paid by the partnership to Elgin R. Parker was adequate compensation for the services he rendered to the business for the fiscal year ended October 31, 1944.

The appellee introduced no evidence on this point, except that he introduced in evidence over appellants' objection, "Memorandum in re Incidence of Federal Tax Liability on 1944 Partnership Income."

The Record, pages 55 and 56, shows the trial on this point, as follows:

> "Mr. Garland: May I now offer in evidence, the certification of some twenty-eight documents listed on the first page, being authenticated, and is substantially the entire file, as I understand, at least part of the file of the guardianship estates. I will introduce all these papers.
>
> The Court: Any objection?
>
> Mr. Wilson: I object to the one that he has been discussing, because it has a statement by Mr. Parker as to the status of the law on family partnerships, which is a matter of opinion and could not be taken as an admission of any kind by him. And also the same objection is made to the memorandum signed by myself. It states matters of opinion.
>
> Mr. Garland: I have made my offer.
>
> Mr. Wilson: To the rest of them I have no objection.
>
> The Court: They will be introduced.
>
> The Clerk: Defendant's Exhibit A in evidence.
>
> (The documents referred to were marked Defendant's Exhibit A and were received in evidence.)"
>
> [Testimony of Elgin R. Parker]:
>
> "The Memorandum in re Incidence of Federal Income Taxation on Partnership Income signed by Melvin D. Wilson does not bear my signature. I authorized him to file papers on my behalf in the guardianship matter.
>
> Mr. Garland: This memorandum is on page 2 of the Memorandum in re Incidence of Federal Income Tax Liability on 1944 partnership income: 'The father received a salary of but $12,000.00, whereas

> his services were worth at least $52,000.00 per year. If a fair and full salary of $52,000.00 per year had been paid the father, a result more comparable to that shown in situation C would have obtained."

This memorandum was filed with the Superior Court by appellants' counsel without appellants' knowledge and without any information or advice from them. It contained a statement by the counsel that Elgin R. Parker's services were worth $52,000.00 per year. This was an expression of opinion by a person not shown to be qualified as having a worthwhile opinion on this point and furthermore it was a statement of opinion and not a statement of fact. It was made without the appellants' knowledge and without any information or advice having been given by them to their counsel on such point.

This matter was read to the jury and much was made of it in the argument by appellee's attorney.

In 31 Corpus Juris Secundum, page 1025, the rule with respect to admissions against interests is as follows:

> "To be competent as an admission, a statement must be one of fact, and a statement which is a mere opinion or conclusion or a conclusion of law is as a rule inadmissible."

The Judge erred in admitting such a conclusion in evidence and erred in allowing it to be read and argued to the jury. This error of the Court and appellee's argument based thereon, influenced the jury into thinking that perhaps Mr. Parker had not been fully compensated for his services to the partnership and that some of the income which should have been taxed in his returns, was taxed in the children's returns. This constituted an error on a substantial point and is ground for reversal.

IV.

The Court Erred in Admitting Over Appellants' Objection, "Application for Authority to Compromise Claims," Filed August 27, 1946.

The Court admitted into evidence this Application for Authority to Compromise Claim found on pages 110 to 116 of the Record over the objection of the appellants. The jury took this exhibit and all others to the jury room and it is presumed that they read it and considered it.

That exhibit contained the following statement:

> "It seems entirely probable that the claims of the Commissioner of Internal Revenue in this case will be sustained by the Tax Court and the other Courts of the United States and by the State tax authorities. Your petitioner and his wife will probably file protests and endeavor to effect some settlement and saving of tax but it appears that this is an undertaking with very little prospect of success." [R. 113.]

Appellants' objection to the admission of this statement is stated on page 55 of the record as follows:

> "Mr. Garland: May I now offer it in evidence, the certification of some twenty-eight documents listed on the first page, being authenticated, and is substantially the entire file, as I understand, at least part of the file of the guardianship estate. I will introduce all these papers.
>
> The Court: Any objection?
>
> Mr. Wilson: I object to the one that he has been discussing, because it has a statement by Mr. Parker as to the status of the law on family partnerships, which is a matter of opinion and could not be taken as an admission of any kind by him. * * *
>
> Mr. Garland: I have made my offer.

Mr. Wilson: To the rest of them I have no objection.

The Court: They will be introduced.

The Clerk: Defendant's Exhibit A in evidence.

(The documents referred to were marked Defendant's Exhibit A and were received in evidence.)"

Here again this was not a statement of fact but a mere conclusion and in addition was a conclusion of law, made by a layman.

Now it is clear from the authorities cited in 31 Corpus Juris Secundum, page 1025, that legal conclusions of the party are not admissible in evidence as admissions against him. This is true also when it involved matters of law and fact.

The statement made in this Application [R. 113] might easily lead the jury to believe that the prosecution of these suits by the appellants was entirely speculative and opportunistic. As a matter of law it is obvious, of course, that the decisions were for the most part against family partnerships, until the Supreme Court decision in *Commissioner v. Culbertson, supra,* which was handed down on June 27, 1949. That case recognized the principles for which the appellants have been contending from the beginning, but for a long time it did not seem that the courts were going to recognize the principles which the Supreme Court eventually held to be correct.

In any event, it was error for the Judge to admit this statement in evidence and it probably had a considerable influence on the jury. Therefore it constitutes reversible error.

V.

The Evidence Was Wholly Insufficient to Support the Implied Finding of the Jury That This Partnership Was a Sham and the Implied Finding That It Was Not Entered Into for the Purpose of Carrying on the Business as a Bona Fide Partnership.

Without an affirmative instruction from the Court that the contributions by the children to the partnership of interests in the business given to them by their parents, was sufficient for the recognition of them as partners for income tax purposes, the appellants never had a chance for a favorable verdict from the jury. Since the children did not contribute services nor original capital, their entire chance for recognition depended upon their ownership of a portion of the assets and their contribution of these assets to the partnership. Never once did the Court tell the jury in affirmative language that this contribution could be sufficient, if combined with other pertinent factors.

Appellants requested the Judge to make such an affirmative instruction and took exception when he refused to do so. When the jury came back into the court room the second time, the jury asked for an instruction on this specific point and again the Judge refused to give them one. Appellants had already taken exception to such refusal and, of course, did not consider it necessary to take another exception on the same point. The law does not require a person to perform a futile act.

Consequently, the keystone of appellants' case was removed by the Judge's faulty instructions and the jury reached an erroneous verdict. If the Judge had properly instructed the jury along the lines indicated by the Supreme Court in *Commissioner v. Culbertson, supra,* it is believed that the jury would have found for the appellants. All the other elements necessary for recognition of the children as partners were present in this case, as will be outlined hereinafter.

The parents made complete, irrevocable and unconditional gifts of interests in the business to the children for reasons not concerned with tax avoidance. The deeds covering these gifts were acknowledged before a notary public and were recorded. They were reported to the Commissioner of Internal Revenue in gift tax returns and he determined that the gifts were valid, complete, unconditional and irrevocable and imposed taxes thereon. He not only imposed gift taxes on the transfer of the tangible property but additional gift tax on the intangible property of the business.

After the children became owners of interests in the assets and business, it was necessary for all the owners to form an organization to carry on the business. Appellants applied to the Superior Court in the county in which they resided, for the appointment of a guardian to look after the children's interests under the supervision of the Court. A guardian was appointed, provided he filed bonds. Before he could procure bonds he had to secure from the Court permission to keep the children's assets in the business, permission to sign the partnership agreement, approval of the partnership agreement and permission to retain some of the earnings in the business. Thereafter annual accounts were filed with, and approved by, the Court, and all important steps were presented to the Court and given its approval before they were made.

The children's earnings were credited to them and some distribution was made in 1945. In 1948 the partnership was dissolved and the children's greatly enhanced interests were distributed to their guardian.

The parents continued to support the children and none of the children's income was used for their support or for the support of the parents.

The children's Federal income tax refunds were loaned to the parents to enable them to pay their income tax deficiencies, upon the condition that if the parents won their income tax litigation they would return the refunds to the children with the interest benefits obtained, and if the parents lost their income tax litigation, they would keep the refunds and be free to ask the Court for a further adjustment. It had been indicated in an earlier application to the Court, which was not acted upon, that if the parents lost the income tax litigation they would probably ask the Court to approve a division of the income, after all income taxes of all the partners had been deducted, to the extent of 50% to the parents and 50% to the children. If the Probate Court approved this plan, it would still leave the children a very handsome income on their investment.

While Elgin R. Parker was appointed guardian, he was under the control of the Court and through this means the Court had four votes in all partnership matters as against two for the appellants. Section 15018(e) of California Corporations Code provides that "all partners have equal rights in the management and conduct of the partnership business." Consequently, the Court controlled the partnership and the business. The guardian took an oath to comply with the law and gave bond to do so.

The appellants actually gave up half of their capital and half of their income and hence their economic interests were greatly reduced.

The purpose of the transfer to the children was to interest them in the business so that it could be continued even after the death of the appellants and to give the children some property and income, in the event that disaster again befell the appellants, as it had once before. They decided to make these transfers to the children before they ever consulted tax, accounting or legal counsel. While Elgin R. Parker realized that the family income taxes would be reduced if the children were recognized as partners, Flo Parker did not realize this and hence, it had no part in the reasons and purposes for which she made the gift. Her half of the property was her separate property and she managed it herself, with her husband's assistance.

The partnership paid Elgin R. Parker the full value of his services rendered to the business in the year ended October 31, 1944. His salary was first established in November of 1942, when the partnership with his wife was made. At that time, $12,000.00 per year was plainly adequate, considering the size of the business. Many cases dealing with reasonable compensation for income tax purposes, have established the principle that:

> "Additional compensation during the war years may not have been justified where the circumstances disclose increased income without correspondingly increased work or activities of officer-stockholder." 1950 Prentice-Hall Federal Tax Service, Paragraph 11,703 J, and cases digested at Paragraph 11,703 K.

In Regulation 111, Section 29.23(a)(6)(3), the following rule is laid down with respect to the determination of the reasonableness of salaries:

> "The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned."

There was no evidence that E. R. Parker worked any harder in 1944 than he did in 1942. War housing called for more of his products, and he was fortunate in securing materials. The additional business just fell into his hands. Since Elgin R. Parker was adequately compensated for his services, and Flo Parker rendered no services to the business, none of the income which should have been reported in the returns of the parents was reported in the returns of the children.

The children owned half of the tangible and intangible capital of the business and this capital produced all of its net income, after deducting the salary to the father. The children owned a half interest in the business and a half interest in the net income and such income should not have been taxed to the parents.

The facts of this case meet all the tests laid down by the Supreme Court in *Commissioner v. Culbertson, supra,* wherein it said:

> "The fact that transfers to members of the family group may be mere camouflage does not, however, mean that they invariably are. The Tower case recognized that one's participation in control and management of the business is a circumstance indicating an intent to be a bona fide partner despite the fact that the capital contributed originated elsewhere in

> the family. If the donee of property who then invests it in the family partnership exercises dominion and control over that property—and through that control influences the conduct of the partnership and the disposition of its income—he may well be a true partner. Whether he is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise."

The children in this case were donees of property and they invested it in the family partnership. Through the Superior Court they exercised dominion and control over their property, and in fact over the parents' interest in the business, and through that control they influenced the conduct of the partnership and the disposition of its income. They received their shares of the income. They were intended to be and were true partners.

The Court further said in *Commissioner v. Culbertson, supra*:

> "The facts may indicate, on the contrary, that the amount thus contributed and the income therefrom should be considered the property of the donee for tax, as well as general law, purposes."

The parents completely gave away half of their property and the income therefrom. They no longer retained it. They put it as far from them as they could by putting it under the control of the Court and they gave it to the children and the children received it and kept it. The Court really dominated the business and its management. The property produced the income here involved, as the parents were fully paid for their services rendered to the company. The parents did not use any of the children's income either for the support of the children or for the parents and there has been no "Indian Gift" such as was present in the *Tower* and *Lusthaus* cases.

The fact that the parents borrowed the children's refunds, with the approval of the Probate Court, does not amount to a taking of some of the children's income or assets. It is to be returned, with interest, if the parents win their income tax case.

The possibility that the parents may keep the children's refunds of income tax, or may, with the Probate Court's approval, get even a greater adjustment from the children in the event the parents lose their income tax case, does not negate the bona fide intention to make the children partners or to make complete, unconditional gifts to the children. As to the children's refunds, they should rightfully be applied against the tax on the children's income, even though that tax will be assessed against appellants if they lose the income tax case. It is still a tax on income belonging to the children. If any additional allowance is made to the parents by the Probate Court, it would be because the tax *on the children's income* would, if the parents lose the income tax case, be larger than if assessed against the children. But the children would simply be *paying a larger tax on their own income*—not giving the parents anything.

In *William M. Lamb v. Francis R. Smith,* decided by the U. S. Court of Appeals for the Third Circuit, July 28, 1950, Paragraph 72,666 of 1950 Prentice-Hall Federal Tax Service, there was also an adjustment between the partners on account of additional income taxes paid by the husband—assessed because the wife and minor children were not treated by the Commissioner as partners. There the additional taxes against the family were paid out of partnership income, thus reducing the distributive income of the wife and children, as well as the father. No doubt the father used the children's income tax refunds, also. Page 44a of Appendix to Brief for the Appellant in the above entitled case.

Nevertheless, the jury found the wife and minor children were partners, and the Appellate Court upheld the verdict.

In the case at bar, the children were the real owners, legal and equitable, of the property, tangible and intangible, which produced the income. They received that income, and through the Probate Court and the guardian they controlled the business. There is no sham and they should be recognized as partners.

The principles for which appellants are contending are well expressed and strongly supported by the Senate Committee on Finance, in its Report to accompany H. R. 8920, dated August 22, 1950, found in the Appendix to this brief. In the Appendix also appear the provisions of Section 222 of H. R. 8920.

If said Section 222 becomes law, it will dispose of this case, in favor of the appellants.

If, for any political or fiscal reason, the said section is deleted from the law, the views of the Committee still constitute a clear statement of the present law on the subject of family partnerships—with the fog of confused thinking cleared away—a statement by some of the ablest lawyers, and best students of taxation, in the Senate.

An outline of the Committee Report follows:

1. Income from property is taxable to the owner of the property.

2. Income from personal services is taxable to the person rendering the services.

3. There is no different rule applying to partnership income.

4. The Tax Court has incorrectly established a rule that an intrafamily gift of a partnership interest, when the donee performs no substantial services, cannot be the basis of a valid partnership for tax purposes.

5. The owner of an interest in a partnership is taxable on the income from that interest, however he may have acquired that interest.

6. Arrangements between family members should be closely scrutinized, to see if the transactions are real or sham.

7. If the ownership is real, it is immaterial that (1) the donor desired to save income taxes or (2) that the business did not benefit from the entrance of the new partner; a gift is not normally motivated by any business purpose.

8. If the apparent ownership is a sham, it will be disregarded.

9. True ownership by the donee need not be negated by substantial powers retained by the donor (1) as a managing partner, or (2) as a fiduciary, since these powers are to be exercised for the benefit of the donees and not for the donors.

10. The donor may not be taxed on the income from property truly given to another.

11. The value of personal services is to be taxed only to the partner performing them, and the income from property is to be taxed to the true owners.

12. The fact that a reallocation of the income between services and property is necessary, does not require the nonrecognition as a partner of a donee of property.

The facts in the case at bar fully meet all the tests set up by the Senate Committee. The facts also fully satisfy the tests made by the Supreme Court.

The appellants went all the way; they made complete gifts to their children, to benefit the children; they intended their children to be partners; they gave up all their legal and beneficial interest in and control over the property; they took an adequate salary for personal services rendered; they did not use or receive any of the children's income or property; the children have influenced the conduct of the business, through the Court and guardian, and have received and enjoyed their income and property. There is no sham, no under-the-table-strings, no "Indian Gift," no invisible control. The children are the real owners of the property and of the income, and no one but the children should be taxed thereon.

For decisions of the United States Circuit Courts of Appeal recognizing minor children as partners where the children rendered no services and made their contributions from capital donated by their partner-parents, see

Milton Greenberger v. Commissioner, 177 F. 2d 990, C. C. A. 7; *Thompson v. Rigg,* 175 F. 2d 81 (no petition for certiorari), C. C. A. 8; *Thomas v. Feldman,* 158 F. 2d 488, C. C. A. 5; *Armstrong v. Commissioner,* 143 F. 2d 760, C. C. A. 10 (no petition for certiorari); *Walsh v. Commissioner,* 170 F. 2d 535, C. C. A. 8. In at least two of the cases, *Milton Greenberger v. Commissioner, supra,* and *Thomas v. Feldman, supra,* the saving of income taxes was at least an incidental object of the gifts and the formation of the partnership. In one case, *Armstrong v. Commissioner, supra,* the father was sole trustee for the minor children and had broad powers. In two other cases, *Thompson v. Rigg, supra,* and *Thomas v. Feldman, supra,* the father was a trustee with others. In *Walsh v. Commissioner, supra,* there was a guardianship for a minor child and the father was the guardian. The guardian was the son of the prior owner of the business (the donor of the interest to the grandchildren).

If the jury in the case at bar had been properly instructed as to the law as indicated by the authorities cited in this brief—that minor children who contribute interests in the business which was donated to them by their parents, can be recognized as partners, even though the children render no services and tax saving was one of the objects of the gifts, if the gifts were genuine and complete and the children were the real owners of the interests, and the children were intended to be partners—the jury would undoubtedly have found for the appellants.

Conclusions.

Appellants contend that the verdicts and judgments were erroneous because of errors by the Court in its instructions, and because of the fact that the evidence does not support the implied findings of the jury that the partnership was a sham. The judgments below, therefore, should be reversed.

Dated at Los Angeles, California, this 15th day of September, 1950.

Respectfully submitted,

Melvin D. Wilson,

Counsel for Appellants.

APPENDIX.

(110) Section 222 of H. R. 8920, on Family Partnerships states as follows:

"(a) Definition of Partner.—Section 3797(a)(2) is hereby amended by adding at the end thereof the following: 'A person shall be recognized as a partner for income-tax purposes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.'

(b) Allocation of Family Partnership Income.—Supplement F of chapter 1 is hereby amended by adding at the end thereof the following new section:

'Sec. 191. Family Partnerships.

'In case of a family partnership, the allocation of partnership income according to the terms of the partnership agreement shall be recognized unless such allocation does not substantially reflect the proportionate value of the services or capital of the family members, taking into account the contribution of services and capital of each. If it does not so reflect the proportionate value of services, a reasonable proportionate allowance for such services shall be attributed to the partners rendering such services. The fact that a partner does not actively participate in the management or conduct of the partnership business shall be taken into account in determining the proportionate value of services and capital, but shall not otherwise affect his status as a partner. For the purpose of this section, the term "family partnership" shall mean any partnership as defined in section 3797(a)(2) which includes two or more members of the same family as defined in section 24(b)(2)(D), and for this purpose a trust for the benefit of a member of a family shall be considered a member of such family.'

(c) Effective Date.—The amendments made by this section shall be applicable with respect to taxable years beginning after December 31, 1938."

Section XI(B)(4), pages 60 to 63, incl., of the Report of the Committee on Finance accompanying H. R. 8920 states as follows:

(4) Family Partnerships.

"Section 222 of your committee's bill is intended to harmonize the rules governing interests in the so-called 'family partnership' with those generally applicable to other forms of property or business. Two principles governing attribution of income have long been accepted as basic: (1) income from property is attributable to the owner of the property; (2) income from personal services is attributable to the person rendering the services. There is no reason for applying different principles to partnership income. If an individual makes a bona fide gift of real estate, or of a share of corporate stock, the rent or dividend income is taxable to the donee. Although there is no basis under existing statutes for any different treatment of partnership interests, recent judicial and administrative action in this field has ignored the principle that income from property is to be taxed to the owner of the property.

Many court decisions since the decision of the Supreme Court in *Commissioner v. Culbertson* (337 U. S. 733) have held invalid for tax purposes family partnerships which arose by virtue of a gift of a partnership interest from one member of a family to another, where the donee performed no vital services for the partnerships. Some of these cases apparently proceed upon the theory that a partnership cannot be valid for tax purposes unless the intrafamily gift of capital is motivated by a desire to benefit the partnership business. Others seem to assume that a gift of a partnership interest is not complete because the donor contemplates the continued participation in the business of the donated capital. However, the consistency with which the Tax Court, since the Culbertson decision, has held invalid family partnerships based upon donations of capital, and the many reasons advanced in the opinions for such decisions would seem to indicate that, although the opinions often refer to 'intention,' 'business purpose,' 'reality,' and 'control,' they have in practical effect established a rule of law to the effect that an intrafamily gift of a partnership interest, where the donee performs no substantial services, cannot be the basis of a valid partnership for tax purposes. We are informed that the settlement of many cases in the field is being held up by the reliance of the field offices of the Bureau of Internal Revenue upon some such theory. Whether or not the opinion of the Supreme Court in *Commissioner v. Tower* (327 U. S. 280) and in the opinion of the Supreme Court in *Commissioner v. Culbertson* (337 U. S. 733) which attempted to explain the Tower decision, afford any justification for the confusion is not material—the confusion exists.

Your committee's amendment makes it clear that, however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner. If the ownership is real, it does not matter what motivated the transfer to him or whether the business benefited from the entrance of the new partner. The question of the taxability of the income of such interest depends, as in the case of any other donated property, on whether the donee is the real owner of the interest. The amendment is intended to make it clear that there is nothing peculiar in the tax law as applied to partnerships but, on the contrary, that they are governed by the ordinary rules which generally determine the person to whom income is to be taxed.

The amendment leaves the Commissioner and the courts free to inquire in any case whether the donee or purchaser actually owns the interest in the partnership which the transferor purports to have given or sold him. Cases will arise where the gift or sale is a mere sham. Other cases will arise where the transferor retains so many of the incidents of ownership that he will continue to be recognized as a substantial owner of the interest which he purports to have given away, as was held by the Supreme Court in an analogous trust situation involved in the case of *Helvering v. Clifford* (309 U. S. 351). The same standards apply in determining the bona fides of alleged family partnerships as in determining the bona fides of other transactions between family members. Transactions between persons in a close family group, whether or not involving partnership interests, afford much opportunity for deception and should be subject to close scrutiny. All the facts and circumstances at the time of the purported gift and during the periods preceding and following it may be taken into consideration in determining the bona fides or lack of bona fides of a purported gift or sale.

Not every restriction upon the complete and unfettered control by the donee of the property donated will be indicative of sham in the transaction. Contractual restrictions may be of the character incident to the normal relationships among partners. Substantial powers may be retained by the transferor as a managing partner or in any other fiduciary capacity which, when considered in the light of all the circumstances, will not indicate any lack of true ownership in the transferee. In weighing the effect of a retention of any power upon the bona fides of a purported gift or sale, a power exercisable for the benefit of others must be distinguished from a power vested in the transferor for his own benefit.

Your committee's amendment requires that a true partnership relation exist in that each partner must be a real owner of an interest in the enterprise, just as an alleged donee of any other property must actually own it if the income is to be taxable to him rather than to the donor. In the case of a transfer of an interest in a partnership, as of any other property, it is not required that there be any particular motive for the transfer. There need be no purpose that the transfer benefit the business. It is a basic premise that a bona fide gift is not normally motivated by any business purpose; therefore, the fact that any partner's capital interest in a partnership was acquired from a relative in a purely donative and non-business transaction is not to be considered as an adverse factor in determining whether he actually owns an interest in the enterprise. If he does own such an interest in the business, it is immaterial from whom he acquired it or what motivated the transferor in transferring it to him.

Since legislation is now necessary to make clear the fundamental principle that, where there is a real transfer of ownership, a gift of a family partnership interest is to be respected for tax purposes without regard to the motives which actuated the transfer, it is considered appropriate at the same time to provide specific safeguards—whether or not such safeguards may be inherent in the general rule—against the use of the partnership device to accomplish the deflection of income from the real owner. Your committee's bill therefore includes specific provisions to prevent the deflection of personal service income and to prevent the allocation of other income in disproportion to capital interests. Your committee's bill requires that the terms of the partnership agreement are to be disregarded where the allocation under the agreement does not substantially reflect the proportionate value of the services or capital of the family members. In this connection the new section 191 added to the code by your committee's bill while specifically providing that nonparticipation in the management or conduct of the partnership business shall not disqualify a person as a partner, provides that this nonparticipation shall be taken into account in determining the proportionate value of the services and capital of each partner. Where reallocation is necessary, a reasonable proportionate allowance for their services is to be made in determining the income of those partners who rendered services. Reallocation of income other than incomes from personal services may not be predicated upon the fact that the capital of one family member was acquired by gift from another.

The amendments made by this section are applicable for taxable years beginning after December 31, 1938."